DIVERSITY AND CONSENSUS

ASIA'S EMERGING DEVELOPMENT PARADIGM

ADDRESSES BY

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WASHINGTON, D.C.

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Preface

This is a second collection of speeches given by Attila Karaosmanoglu, who has served as vice president for Asia at the World Bank from July 1987 to December 1991. The first collection, entitled Poverty and Prosperity: The Two Realities of Asian Development, appeared over two years ago with a basic theme of the distinctively different development challenges found in East Asia on the one hand and South Asia on the other. The challenge was to bring the development thinking and performance of the slow-growth economies (mostly in South Asia) closer to the remarkable achievements of the high-growth, highly adaptive economies of the East. In the relatively short time that has passed since then, some remarkable developments have taken place in the region. In this second collection of addresses, the central theme is the recent convergence of the East and South toward an emerging consensus on the most productive policies for growth and poverty reduction.

The most striking evidence of this recent shift in thinking is the accelerating transition in India from the culture of economic planning to that of a competitive, market-driven economy. The policy changes undertaken by the Indian government in 1991 mark a watershed in that country's economic history. More quietly and gradually, China has resumed the path to market-based development and a return to the impressive growth performances achieved during its earlier period of economic reforms. In Sri Lanka, important policy shifts are reducing the size of the public sector and creating the framework for accelerated economic growth. In these and other changes, there is the growing acceptance of an Asian growth and development paradigm that over time has demonstrated its consistent success in economic performance, and its replicability in an ever larger circle of Asian economies. The pragmatic policies based on this consensus have taken many forms in different countries and sectors, from the management and owner-

ship of infrastructure in Asia to the innovative approaches to private sector development and the evolution of thinking and practice on government's role in industrial growth. Japan's role as a contributor to this paradigm deserves special note.

The encouraging progress seen recently should not obscure the massive problems faced by Asia in the eradication of poverty, the protection of the environment, and the building of growth momentum in Indochina, the Philippines, Nepal, and Bangladesh. India faces a long, difficult period of far-reaching adjustment and reform. It is not the lack of daunting development obstacles that distinguishes Asia; it is the determination to address them in a timely, pragmatic, and consistent way.

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Sustainable Development
A Multi-Sectoral Perspective

An address to the Asian Development Business Seminar, Vancouver, British Columbia, April 22, 1991.

Sustainable development is a concept of many definitions, whether we interpret it to mean some measure of environmental equilibrium, or intergenerational equity in the transfer of natural resources, or low growth strategies to minimize natural resource depletion or pollution. All of these focus exclusively on the environment, but I will interpret sustainable development today in more broad terms, as a *multi-sectoral approach to sustaining economic development performance*. The natural environment and its preservation are crucial to progress, especially as they affect and are affected by the sources of growth. Let me explain.

In Asia, and elsewhere, sustainable development encompasses a constellation of interactive and complementary strategies. Sustainability means harnessing and preserving the natural, physical, and social resources to fuel long-term growth, and it means employing adept and agile macroeconomic management to forge a consistently stable and expanding economy. Although some natural resources have been eroded rather than created in Asia, this overall approach uniting efficient resource investments with sound economic management has been at the foundation of the Asian success stories. The questions being asked today about this Asian approach is can it be sustained, and can it be extended to the less successful countries of the region, and if so with what modifications?

What I would like to do today is bring to light this story of the changing Asian development challenge, how our understanding of basic processes has evolved in recent years, and how these

changes have shaped our strategies at the World Bank and those of our country borrowers.

Two Asias?

Contrary to the difficult problems that beset most of the developing world in the last decade, the 1980s in Asia can be described as a "stellar decade." During this period Asia's per capita income grew by 5.1 percent per year, nearly twice the rate during the 1960s and 70s. For many, even today, the achievements of Asia's industrializing, high growth economies have created an impression of a region uniformly blessed with economic dynamism and rapid solutions to development problems. From my perspective of working directly with the countries of Asia, from India east to the Pacific Islands, this portrait of Asia as a problem-free zone of development is, of course, oversimplified and overstated. In fact the development problems and prospects of this diverse region create two groups of countries with their own distinctive array of strengths and weaknesses.

In the first Asian group are found the fast growing industrializing nations of East Asia, open to the global economy, and rapidly reducing poverty. The second Asia includes countries mostly in South Asia, with high proportions of their people living in absolute poverty, their economies growing slowly if at all, and rural environmental problems undermining agricultural productivity. Both Asias, however, share a very Asian characteristic I noted earlier of prudent and adept macro-economic management resulting in only rare instances of macro instability and financial crisis. This "two-Asia" interpretation of the region has been for sometime a useful organizing principle for our operational work despite some anomalies and outliers.

In recent years this view of the region has undergone revisions as this most dynamic region of the world has changed more rapidly and in directions that we did not always foresee. Some of these changes blur the dividing line between the two Asias; others intensify it. These changes fall into four different areas: macroeconomic instability; environmental degradation; poverty reduction;

and market based growth strategies. Let me first take up macroeconomic developments.

Macroeconomic Imbalances

The vaunted economic stability of Asian economies has always had its exceptions and problem cases, but recently the scope and depth of such difficulties seems to have expanded. India and China, our two largest borrowers, have both encountered serious imbalances and pressures, requiring from their governments tough decisions and tradeoffs.

For India, the 1980s were a decade of higher growth performance and improved social indicators, but in recent years growing macroeconomic balances became a source of concern. The recent Middle Eastern oil shock precipitated, therefore, an economic crisis with origins long before 1990. Foreign exchange reserves had fallen to 7 weeks of imports by end-July 1990, and major foreign rating agencies were already reviewing India's credit rating, which was subsequently downgraded. The oil shock itself was not as severe as those of 1973-74 or 1979-80, but it hit the Indian economy when it was already on the verge of a foreign exchange liquidity crisis. The additional import costs of higher oil prices, lost remittances and other factors through March 31 was about $1.5 billion, and the current account deficit increased by roughly the same amount for FY1990/91. Fiscal deficits have continued to mount, now at a level equal to about 9 percent of GDP.

The consequences of all these developments were sharply reduced access to external commercial borrowing, the emergence of double-digit inflation, and a fall off in reserves to less than 1 month of imports by end December despite tighter import controls. The IMF made available $1.8 billion to help the government manage the crisis.

Although the economy continued to grow in 1990-91, the prospects for the present year are more conservative. Many pitfalls await the new government, which will need to manage this crisis with skill and dispatch, while also addressing the agenda for structural reform.

The onset of such serious macroeconomic difficulties in India has already exerted a dampening effect on the progress of key economic policy reforms to deregulate industry, liberalize the trade regime and improve the overall environment for private sector activity. These are difficult times indeed, for a country where the hopes of some 300 million poor people depend very directly on stability and accelerated growth.

China's difficulties have been domestically driven but without an external crisis as in India. Inflation rose to unacceptable levels in 1988. Rising price and enterprise subsidies and a declining ratio of government revenue to GDP raised fiscal deficits to 2.5 percent of GDP in 1988. The anti-inflationary policies took the form of administrative guidelines to cut state investment, exert more control over credit allocation, and allow higher interest rates. These policies proved successful in reducing inflation from 18 percent per annum in 1988 to 2.1 percent in 1990, but they have also halved the rate of growth, reducing real GNP growth from 10.9 percent in 1988 to 5 percent in 1990. Unemployment also increased somewhat in this period, with several million transient urban workers being forced to return to the countryside.

China's external situation remains favorable, as continued export growth has had the effect of transforming the 1989 current account deficit into an estimated surplus of about $9 billion by the end of 1990. Realistic exchange rates should allow China to continue to maintain a trade surplus.

Elsewhere in Asia, macro management problems have continued or intensified. The Philippines has seen its promising recovery of the late 1980s succumb to a series of shocks, both domestic and external. Growth has slowed and the deteriorating balance of payments requires concerted international assistance to help the country through the crisis. Sri Lanka, Papua New Guinea, and Viet Nam each have continuing macroeconomic imbalances requiring aggressive adjustment programs. I don't mean to suggest by this account that all of Asia has lost its fiscal discipline and prudence. But we do have a shift upward in the number of problem situations. They will all require some very resolute choices and sacrifices. I have a lot of confidence that they all will be able in time

to take the necessary steps, but they will require decisive support from the international community, a subject to which I will return.

Environmental Degradation

I now turn to the environment, which as a development issue has assumed increasing importance for the Bank over the last five years. In our Asia operations, we have dedicated considerable resources to analyzing the dimensions, causes and solutions of environmental degradation of forests, soils, water supplies, and air quality. When we began this strengthened program we already had accumulated considerable experience in South Asia, where population pressures in rural areas had for many years taken its toll in soil erosion, siltation of rivers and streams, deforestation, and other processes. Our more recent work has brought to light the growing environmental problems of East Asia.

As Asia's population continues to grow, the proportion of the regional population living in cities will also increase. By 2025, some 50 cities in the region will have in excess of 4 million people each, compared to 20 currently. South Asia is expected to have the highest ratio of population in such mega cities by 2025. Many of these cities will have 10 million people or more. Few governments have policies or programs under consideration to cope with the projected rates and associated needs of urbanization. Significant issues regarding environmental pollution and land use allocation are inevitable.

Forest areas are declining in most areas of the region. Rates of decline are highest in Southeast Asia and severe in South Asia. Throughout Asia the rate of deforestation has increased from 2 million hectares per annum in the 1970s to at least 5 million hectares per annum in the 1980s. This has largely resulted from the demand for increased agricultural land, commercial logging and fuel wood collection. The Philippines will see its hardwood forests disappear by the end of the decade at current rates of depletion. The forests of Sabah in Malaysia, a true national treasure, have come under mounting pressure from commercial logging. Although com-

mercial cutting is not the only cause of deforestation, it is subject to regulation, economic pricing, and better management. These are areas where the World Bank can and is making a contribution. The secondary costs of forest depletion are also significant. Soil erosion caused by deforestation is estimated to cost Java alone about $400 million annually (soil productivity loss plus costs of clearing silt from irrigation facilities, rivers, and dams). Deforestation also leads to loss of habitat—about one-quarter of the world's biological resources are at high risk of extinction in the next 20-30 years.

Let me also mention atmospheric pollution in Asian countries which is a matter of both national and international concern. Air pollution is a major threat to human health in cities like Beijing, and children in Bangkok show increasing levels of toxic chemicals in their blood stream from automobile emissions. In addition, the rapid increase in atmospheric emissions in Asia's newly industrializing nations contributes to global problems such as acid rain and possible climate change.

The "greenhouse gases" implicated in global warming are produced mainly by the large developed countries (the U.S., EEC and USSR produce about 50% of greenhouse gases), but the rate of increase is greatest in Asia. Their share of emissions is expected to double in 25 years, with India and China alone making up the major share.

Poverty and Population

The third area where we have changed our thinking and strategy is poverty and population. The dimensions and distribution of poverty in Asia have been well known for some time, both in South Asia where low income, slow growth economies have been unable to significantly reduce the numbers of poor, and in East Asia where the industrializing high growth economies, and here I include China, have achieved truly dramatic reductions in both the numbers and the incidence of poverty. Our analytical work on

poverty, however, has brought to light some very important characteristics of poverty in Asia and pointed the way toward effective public interventions to hasten its reduction.

The reduction of poverty in Asia is tightly bound to population density and to its rapid growth. More than half the world's 5 billion people live in Asia, nearly 35 percent of whom are below 15 years of age. The size of Asia's population in 35 years will be difficult to comprehend as another 1.7 billion people will occupy some of the most densely crowded areas of the world. Looking at measures of density of settlement, consider that Asia has 354 people per square kilometer of agricultural land compared to 55 for Latin America, 58 for Sub-Saharan Africa, and 116 for the Middle East and North Africa. Bangladesh has over 1000 people per square kilometer of agricultural land, India about 450 people. Under such conditions, the pressures on resources—physical and natural—is visible to the most casual of visitors to these places in the world. Social services, if they are provided at all, are delivered at such diluted and low levels of quality that they are left unutilized by discouraged seekers of education and health.

Whether to reduce population growth rates in such countries cannot be debated any longer; vigorous, well funded family planning programs are an indispensable pillar of an Asian anti-poverty strategy. The World Bank has financed population programs in many Asian countries, but we are very concerned to expand the limits of our understanding and to develop new approaches that can have an impact where it is needed most and where it is most difficult to achieve—in the poorest countries of South Asia and in the Philippines.

Poverty reduction, as economists will emphasize, is very difficult to separate from the process of economic growth. Growth generates income, and the historical record is very clear; those countries with sustained growth at moderate to high levels have dramatically reduced poverty. Therefore, policies which encourage growth are the best anti-poverty approach; those that inhibit growth will leave poverty untouched.

In Asia, however, there are wrinkles and complications to that basic truth, and our analysis over the past few years has revealed a few of them:

- Asia's poverty is not only concentrated in a few countries (India, Bangladesh, Nepal, Indonesia, Philippines, Viet Nam, and China), it also tends to be concentrated regionally within those countries. This regional distribution of poverty by state or province is mirrored in striking regional disparities in social indicators and the availability of social and economic services. We therefore have built into our lending program more regionally targeted investment programs to both reach the poor and to lower the intra-country inequities.
- We have also been able to examine more carefully the status of women in Asia, and deepen our understanding of the economic basis for steep gender disparities prevailing primarily in South Asia. The lifting of barriers to women's economic participation is a daunting task in traditional societies, but we have made progress in building into our projects various components that provide poor women with access to social services, credit, training and employment.
- Finally let me mention the role of public expenditure analysis in improving our understanding of poverty and its reduction. A study of Indonesia's record of poverty reduction found that in the mid 1980s when that country was undergoing the rigors of rapid adjustment to diminished oil revenues and cutting back its public expenditure, there was nonetheless a dramatic decline in the incidence of poverty, an outcome we would not have predicted. A major factor was the pattern of public expenditure and its targeting before and during the adjustment period. Social and agricultural services to poor areas were not cut back during the adjustment period, and agricultural policies continued to support poor small farmers. Contrarily, the very low allocations of public expenditures in some countries to poverty directed programs does constrain the provision of services to the poor. In education and health services, countries differ with regard to which services reach the poor more effectively

and those services which do not. Primary education in India, for example, receives a comparatively low proportion of public spending, while higher education receives a disproportionately higher level, leading to severe inequities in educational attainment.

Our thinking on poverty reduction has therefore undergone some significant modifications in recent years, and we are encouraged that more countries in Asia are willing to undertake some of the broad sectoral reforms required to both reach poorer regions and to allocate public expenditure more progressively. We still have a very long way to go.

The Private Sector and Market Based Growth Strategies

Earlier I described how a number of countries in Asia have encountered difficulties in maintaining internal and external balances, resulting in macroeconomic instability. It might be useful now to indicate what the costs of that instability can be. As is obvious to this audience, manifestations of instability are inflation in the domestic economy and a run on foreign exchange reserves on the external side. Less visible but more real in the economic sense are falling levels of investment as investor confidence wanes and capital begins to leave the country. These typical developments reflect the collective judgment of the private sector on the direction of economic policy. The World Bank has long recognized the importance of creating an economic environment in which competition, markets, and investors can operate confidently and smoothly. The recent economic history of Asia provides a wealth of examples to demonstrate both the benefits of maintaining such an environment over time and a few examples of the costs of failing to do so.

It has therefore been a longstanding tenet of Bank strategy to help countries regain macroeconomic stability and to sustain it. More recently, we have become involved in what we call "structural reforms" to deepen and extend the enabling environment for private sector development. This emphasis in our approach has again

emerged from the achievements and lessons of Asia's successful developing economies. In Korea, Thailand, Malaysia, and more recently Indonesia, policies were followed that both streamlined the public sector and facilitated the growth of the private sector through a number of sectoral reforms and investments.

Let me be more explicit. Besides maintaining macro-economic stability, the enabling environment for private sector growth means avoiding major price distortions, creating a sound financial system, providing adequate physical infrastructure, and building a legal environment that respects property rights and enforces contracts. Of particular importance in recent years have been programs for divestiture of public sector enterprises and reducing restrictions on entry of the private sector, both domestic and foreign. There is also increasing acceptance in Asia of the informal sector as the seedbed of entrepreneurs.

This emerging consensus on development strategy—recognition of the importance of incentives, integrated markets and private enterprise—is now widely accepted by the authorities of most Asian LDCs. But the pace of structural reforms for these objectives has been slow in the countries of South Asia. In these economies the trade barriers are still high, investment and commercial activity is still over-regulated, financial markets are distorted and the labor markets are seriously segmented. There are also compelling reasons for streamlining the public sector and improving policies towards private foreign investments and technology transfers.

In addition to Korea, Malaysia and Thailand, the programs for liberalization and private sector development adopted in Indonesia in recent years can provide an apt example that others in the region can follow. But while the directions are similar, differences in country situations call for careful design and sequencing of reforms. India will have to synchronize its industrial policy reform with appropriate changes in its tax structure and trade policy. Other countries of South Asia and the Philippines will have to strengthen the management of public resources while improving the implementation of their trade and financial reforms.

China will need to tackle the difficult core of decisions that ultimately have to be faced by all centrally controlled economies moving to a market system. Issues related to market price formation, property rights, rationalization of the investment system and the problems of fiscal and financial decentralization can no longer be sidestepped if the reform process is to enter a new phase.

Conclusion

At the outset, I said that I would address sustainable development from a multi-sectoral perspective, both because environment is closely linked to other development processes, and because today in Asia, the policy question most heard and of most concern is the sustainability of the remarkable performance achieved in the 1980s and its extension to the less successful economies of the region.

For some countries, this question is less urgent. Korea, Thailand, Malaysia, and Indonesia as well as the already developed economies of the region view sustainability questions from a different perspective, than those countries struggling more directly with obstacles to growth and the destruction of their natural resources. These more dynamic and well managed economies also have the resources and are developing the capacity to begin to address complex issues of environmental preservation and the inevitable tradeoffs with growth objectives.

But I want to be candid about which countries face sustainability problems in this broad sense I have used today and where I hope the World Bank can bring to bear even more significant assistance, both financial and analytical. These are India, China, the Philippines, Viet Nam, and Sri Lanka, where macroeconomic problems converge with other pressing policy issues and investment needs. Bangladesh and Nepal, while relatively free from macroeconomic instability at the present, nonetheless face very difficult challenges to sustainable development over the longer term. These are the countries where the usual optimistic outlook

for Asia requires tempering, at least in the short run, and where the role of the international development community will be most in demand.

I would like to point out that for some of these countries, there are significant obstacles, both externally imposed or domestically created, to an expanded program of assistance by the World Bank and other donors. I cannot emphasize enough how important and urgent it is for these obstacles to be removed, especially those over which the international community has direct control. Only in this way can we expect the process of stabilization, structural reform, poverty reduction and environmental preservation to go forward at the rate and level of effectiveness that will make a difference.

Infrastructure in Pacific Asia
New Priorities for Development

An address to the PacRim Forum,
San Francisco, California, September 10, 1990.

In the developing world, infrastructure is vital to the rapid growth paths these countries must achieve to rise out of poverty. Infrastructure inadequacies can and do depress growth; on the other hand good infrastructure can accelerate growth. Over the last decade, the importance of infrastructure was overshadowed by the rise of macroeconomic instabilities and financial crisis in the developing world. Priorities shifted to short term crisis management of economies teetering on the edge of disaster. Infrastructure received less attention, and in many parts of the world deteriorated badly. Today there is talk of an infrastructure crisis.

Indeed in some parts of the world the situation has reached crisis proportions, certainly in most of Sub-Saharan Africa and parts of Latin America. But not for most of the Pacific Asian countries. There infrastructure investments and management practices have better kept up with demand over the years. The outcries we hear from users for better services is not a sign of failure, not an indication of severe infrastructure deficiencies retarding economic progress, but a measure of buoyant economic growth pushing against strained infrastructure capacities. These are infrastructure problems that most developing countries would welcome.

Infrastructure in Pacific Asia may be comparatively better off, but the situation is not homogeneous, nor is it static. Important changes are underway in the infrastructure subsectors which are altering the ways that infrastructure is owned, managed and financed. These changes are taking place in the high growth countries, where we find an unusual confluence of events, driving the pace of change. These events are: first, surging infrastructure demand; second, stretched financial and managerial capacities in

the public sector; and third, the growing acceptance of many innovative approaches for managing public-private sector collaboration. I want to sketch today from an economic perspective some of these changes in various Asian countries, their implications for governments and the private sector, and conclude with a word on the infrastructure strategy of the World Bank in Pacific Asia.

Patterns of Infrastructure Demand

The familiar pattern of demand for infrastructure outpacing supply characterizes most Pacific Asian countries. These economies are growing at rates well above five percent per year and in some cases are reaching double digits. We know that growth in national output typically generates demand for even higher rates of transport infrastructure growth, so that transport investments should grow at, for instance, 1.2 percent to keep pace with the demand generated by every 1 percent growth in national output. Even higher elasticities may apply to the demand for telecommunications, airports, and urban transit. These patterns of demand for infrastructure can impose tremendous strains on public budgets when economic growth soars up to the 7 to 10 percent range as we see today in Thailand and Indonesia.

In another era, transport investments also placed strains on public budgets, but by leading, not following demand. You will all recall the great railroad investments in the last century that opened up huge areas of the United States and many other countries for development. For many years these demand creating and demand leading investments operated at a loss as high construction costs and fixed operating costs could not be covered by the meager revenues in the early years of operation. The difference had to be met through public subsidy, refinancing, or default.

These were lumpy, indivisible investments, with strong economic externalities and monopoly power over markets. Such characteristics have long defined infrastructure investments and have justified their treatment as a public good, to be owned, regulated and financed by the public sector. Today, this traditional view of infrastructure is to some extent being overtaken by new financing

mechanisms, ownership patterns, management innovations, and technological advances, each of which tend to blur the public/private boundary, while permitting investments to more closely track rather than lead demand. At the same time, attention has focussed on important externalities of infrastructure, such as environmental impact and poverty reduction, both of which require an active role from the public sector. These developments, global in scope, have been slow to reach the developing world. In Pacific Asia, however, these patterns are visibly beginning to take hold.

Country Typologies

Asian countries and indeed all countries fall into a rough three part typology based on demand for infrastructure. In the first category, we would place the impoverished countries with low and stagnant demand and severely neglected infrastructure. These are the crisis countries referred to earlier, where infrastructure is in such a deplorable state that it is in itself a significant constraint on economic growth. In these countries, some governments have understandably sought shortcuts to growth and have turned to large scale infrastructure projects to lead demand and stimulate development, with mixed results. Examples of such crisis countries in Asia would be confined to Indochina.

In the second category, we would find countries with slowly growing demand and an adequate, if not always efficient or up to date, infrastructure endowment. We might call these the "small gap" countries because demand is not rapidly outgrowing the supply of infrastructure. In Asia this category would apply to a number of countries whose growth faltered in the mid-1980s thus slowing demand, and whose momentum of infrastructure investments caught and in some cases exceeded demand. Only the Philippines remains in this category as growth has not yet recovered sufficiently to create large imbalances.

In the third category are what I would describe as the "large gap" countries, which have experienced near boom conditions recently and where demand for infrastructure is surging so rapidly that government infrastructure investments are not keeping pace. If the

gap gets to be too large, infrastructure inadequacies could become a drag on growth. Thailand, Malaysia, and Indonesia have joined this group in the last few years. China belongs in this category unless the abrupt downturn in growth continues.

Given current conditions in the region, most of the countries fit into this last "large gap" category. This raises two questions. The first is whether demand is likely to continue to grow at such a vigorous pace, and the second is how these countries should manage their infrastructure development under such pressing conditions.

Economic Growth Prospects

Let us first briefly examine the prospects for economic growth in the region and its likely impact on infrastructure demand. Our outlook is cautiously optimistic despite a number of familiar and unfamiliar uncertainties. The slowdown in regional growth from about 10 percent in 1988 to 5 percent in 1989 does not in itself signal a loss of growth momentum. Some slowing was probably inevitable in the NICs after a decade of accelerating growth. In the ASEAN countries, performance in 1989 was unexpectedly strong and 1990 might see another year of robust growth. China and the Philippines are the special cases in which there are many outstanding policy issues in need of urgent attention. But overall, we believe that the economic framework of macro stability and outward orientation which has served these countries so well in the past will remain even more relevant and effective in today's volatile global conditions.

But such conclusions must be weighed against the recent events in the Middle East and their impact. We have analyzed the effects of oil prices, remittances, lost export markets, and higher interest rates, and based on oil prices remaining in the mid 20s, the outlook is sanguine for most of our developing country clients. This assumes that their policy choices will include financial restraint, passing through oil price increases, and intensifying already strong structural adjustment policies. The prominent exception is the Philippines, where the shock is relatively large in relation to GDP

and weakened external positions. There, disruptions to output, prices, and external balances could be large.

Coping with Surging Infrastructure Demand

The composition of Asia's growth has changed in recent decades and will continue to do so as manufacturing continues its ascent in its share of GDP and exports gain in the share of national income. Exports as a share of GDP climbed from 8 percent in 1965 to 30 percent in 1988, the highest of any region in the world by substantial margins, and the share of manufactures in exports is also the highest, from 23 percent in 1965 to 74 percent in 1988. This makes for a distinctively Asian composition of growth which has and will exert pressures on some infrastructure subsectors more than others over the long term, namely telecommunications and transport, and in some cases, power. But in the boom conditions prevailing in these countries, it is frankly hard to tell on a year to year basis. What data we have on total investments in the infrastructure subsectors shows a mixed picture as public budgets in unique country environments are shifted to higher demand subsectors from other areas of past emphasis.

Let me cite a few examples of these subsectoral shifts. For Indonesia, 20 percent of development expenditures in Repelita V, the government's planning document for 1990-94, will go to transport and communications, up from 16 percent in the previous planning period. Perhaps you may have seen the recent publicly reported remarks of an Indonesian telecommunications official, who observed that the huge gap between supply and demand was continuing even as the government installed some 400,000 new lines. I should add that for Indonesia, spiralling demand is the sort of good news which that country has struggled through years of patient adjustment to achieve. The World Bank is involved in financing parts of two very large telecom projects, worth $1 billion each, which should at least put a large dent in this problem. One was approved last year and the second will come to the Bank's Board in FY93.

This audience needs no introduction to the transportation woes of Thailand, especially around the capital of Bangkok. Four years of buoyant economic growth have created almost impassable road congestion. After some years of relative decline in transport expenditures, the Government is planning to sharply increase outlays in the 1992-96 development plan.

In Korea, the power sector has also been overtaken by surging demand for electricity. Befitting Korea's advanced developmental status, the source of this unexpected rise in demand is primarily household consumers, now equipped with electrical appliances, such as air conditioners they did not have before, and encouraged to use them by electricity prices below marginal costs of production. Korea will reactivate 14 oil fired generation plants to meet demand and spend $28 billion over the next decade to build about two dozen new plants.

In China, transport networks were under severe pressure before the recent slowdown in growth. Rails along the coast had been operating at 140 to 160 percent of capacity, and China's road density by area or by population is among the lowest among the large countries. Electric power consumption per capita is also very low and power rationing is severe. Even with the short breathing period created by slower economic growth, China will still require enormous infrastructure investments, now estimated at about $100 billion for rail, roads, and power over the next five years.

To adequately cope with these supply/demand imbalances, the fast growing Asian economies will need to do more than simply reallocate scarce budget resources to infrastructure investments. The competing demands of other sectors in the economy and the difficulties of increasing tax collections will leave these governments little choice but to enter into innovative management and new partnerships to solve their infrastructure problems.

New Infrastructure Approaches in Pacific Asia

Asian countries are in fact experimenting with new approaches to infrastructure. Once unquestioned public monopolies are being shared with private providers; the once exclusive preoccupation

with new investments is now partnered with methods to increase operational efficiency and control demand; a once complete reliance on the public budget has opened up to tap other sources of finance. Let us look at a few examples of these positive developments, limited in scope as they may be.

New Management Approaches. Two recent World Bank studies on roads and power infrastructure in developing countries came to similar distressing conclusions—that the performance of infrastructure in these sectors was low and getting worse, and that better maintenance and operation of these assets was needed immediately.

Pacific Asia is not immune to efficiency problems and the need for better management. The Philippines power sector is hobbled by rising technical and non-technical (meter tampering) system losses, not to mention its oil-fired thermal plants around Manila which were allowed to deteriorate to very poor operating conditions. Combined with other difficulties in power investments, Manila now finds itself subject to almost daily power outages.

Finding ways to encourage adequate maintenance and operation is a long term problem in many countries. In the power sector, a lack of efficiency incentives and government interference in utility management is widespread. To address these chronic problems, Asian countries are looking at several options involving the private sector including operational leasing arrangements in which the lessor operates and maintains the power installation, or contracting out maintenance and rehabilitation services to private firms.

Demand management is another innovative approach to limit utilization and increase efficiency. It is receiving increased attention in Asia, including Korea whose electricity pricing policies in the past encouraged excessive household demand. Similarly in Indonesia, current residential power tariffs are well below marginal costs, a situation which both increases demand while depriving the system of resources to finance needed investments in generation and distribution. These highly subsidized tariffs have been justified in the past on equity grounds, but actual utilization patterns in Indo-

nesia show the poor receive only 5 percent of the subsidy. The World Bank and the Indonesian government are actively collaborating on policies to rationalize energy pricing and to target subsidies more accurately to the poor.

New Patterns of Ownership. I turn now to the new approaches to private ownership in the infrastructure subsectors. It needs to be said at the outset that private ownership should not be advocated or pursued on the basis of ideology, because privatization itself should not be the objective. Efficiency *is*, and Asian countries are experimenting with private ownership of infrastructure because it is expected to deliver increased efficiency through competitive markets. Private ownership in its many variations can tap private capital markets, relieve public budgetary pressures, and accelerate access to technology.

Two subsectors which have seen considerable private sector activity are telecommunications and power. Technological advances have reduced the scale of efficient investments and radically altered the monopoly characteristics of telecommunications, making it possible for competing firms to serve the same population. The Philippines telecom sector has been privately owned with minor public participation since 1900, but neither efficiency nor equity objectives are currently being met. A private monopolist controls 60 percent of services, which are concentrated in the more profitable areas of the country, leaving many rural areas unserved. Service quality is substandard. Recent steps by the government include the introduction of more competition by allowing new firms to offer services, and regulatory measures to assure connections to all regions of the country. It is too early to measure results, but policy is now correctly focussed on efficiency and equity gains using private participation as a means, not an end.

The power sector in Thailand has also seen shifts in policy toward private ownership. Last year the government for the first time opened the sector to private participation in cogeneration and independent power generation. Later the government identified 10 future public projects under the Electricity Generating Authority of Thailand in which the private sector could directly own up to 40 percent of total capital requirements. In coal mining, the gov-

ernment is now using joint venture instruments and contracting out to involve the private sector.

New Financing Approaches. The enormous financing requirements of the "large gap" countries are leading some to adopt innovative "build-operate-transfer" or BOT schemes. More than just a private financing mechanism, these capture efficiency gains and maintain public involvement. Thailand is the pacesetter here with a growing list of BOT projects in the road and rail sectors in and around Bangkok, such as the Second Stage Expressway with Japan's Kumagai-Gumi and a $3.1 billion dollar project to build a 60 kilometer elevated rail and road transport system with Hopewell Holdings of Hong Kong. BOT instruments will also figure in the elaborate Eastern Seaboard Development Program, which the World Bank, I am reluctant to confess, was at one time less than enthusiastic about because we didn't foresee the necessary demand and were concerned with its impact on public finances. That project is now needed just to meet the increased demand. Asia is full of surprises.

For many countries cost recovery through user charges has long been an infrastructure financing necessity. But for some subsectors, pricing is still below marginal cost. Subsidizing commercially valuable services is difficult to justify, and as I mentioned earlier, pricing policies are under review all over Asia. Many other financing innovations are under consideration or experiment.

The complex interplay of management techniques, ownership changes, and financing approaches to achieve different infrastructure objectives is perhaps *the* defining characteristic of Pacific Asia's infrastructure strategies. Changes to traditional patterns and methods of *public* finance of *public* investments run by *public* enterprises are gaining some momentum in this region, perhaps faster than in any other.

Dimensions of Infrastructure Investments

Let me now provide some idea of the dimensions of infrastructure investments. It is difficult even to estimate the total size of infra-

structure investments in Pacific Asia, because our data is confined largely to public sector investments. But we can suggest orders of magnitude. For the developing economies of Pacific Asia, and that excludes Taiwan (China), Hong Kong and Singapore, we very conservatively estimate total public sector investments in telecom, transport, power, and water supply at about $120 billion dollars over the last five years. For the next five years, we know that there will be an increase, at least to $140 billion - $150 billion, probably a good deal more. Of that total investment figure, the World Bank finances about 4-5 percent (about $7 billion over the next five years). For Indonesia, the Bank's share will be 20 percent over the next five years, the highest proportion in the region.

Although our share is modest, World Bank projects are of course subject to rigorous standards of competitive procurement. Patterns of procurement tell a good deal about where the more traditional infrastructure opportunities are likely to develop in the region.

Opportunities for Private Sector

Contracts won by foreign vs. domestic contractors and suppliers on World Bank projects show some distinctive patterns in Asia. First, the poorest counties in South and Southeast Asia are the most heavily dependent on foreign suppliers and contractors. India and China, although poor in per capita income terms, nonetheless have huge internal markets and supply much of their own infrastructure needs, excluding of course the very large and difficult projects. The NICs and ASEAN countries are the most self sufficient. Second, we find that all over Asia, local contractors win most of the works contracts while contracts for equipment are more mixed with foreign suppliers competitive in a number of countries. Third, we see the high tech sectors such as telecom more likely to award to foreign firms, and low tech sectors such as water supply going to local firms.

These patterns, albeit from a limited sample, have two important implications for the private sector. First, the high flyers of East Asia with all the visible construction activity are not as accessible as they might seem, due to very competitive local firms. Second,

the poorest countries are the most attractive markets in terms of access, and represent long term opportunities.

Now if we look beyond this small, orderly world of World Bank procurement, to the other 95% of infrastructure investments, the situation becomes more complex and in some ways confounding. In the high growth countries like Thailand, Korea, and Indonesia, large scale infrastructure projects financed in part by foreign capital and with high technology requirements are going to well prepared foreign firms. This extends to lower income countries as well, where local firms are not competitive in terms of experience or technology for the increasingly sophisticated and massive projects these countries are mounting. In addition, the availability of low cost financing is a crucial element in successful packages put together by foreign firms, particularly for the lower income countries in the region. It is safe to say that those foreign firms which offer innovative financing, high technology, long term participation arrangements, and technical assistance as part of their packages will enjoy competitive advantages in the emerging infrastructure markets of Asia.

Responsibilities for the Public Sector

Even though private sector participation is gaining some ground, it needs to be said emphatically that the public sector still must play a central role in the provision and supervision of infrastructure. Recent changes have altered the public role at the margins, not at the core of these essentially public goods. In some ways, public responsibilities can be expected to expand to address important externalities to infrastructure construction and management. In this connection I want to say just a few words about environmental issues.

Environmental aspects of infrastructure are numerous and complex. The World Bank in recent years has devoted considerably more resources to understanding, monitoring and investing in environmental improvement. This in part is a response to concerns voiced in industrial countries, but more significantly it is being sustained and expanded by our developing country clients. They are

asking for our help to address environmental problems, such as urban air and water pollution, the impact on people and habitats from construction of large dams, the destruction of tropical forests, and soil erosion.

Increasingly these countries are conducting their own assessments of the environmental impacts of infrastructure projects. Indonesia is a case in point. Responding to a large and vigorous local environmental movement, Indonesia is establishing in each line ministry an Environmental Commission charged with environmental assessment of projects, among other responsibilities. As a measure of the political importance of environmental quality, the government set up in June a pollution monitoring and control agency to oversee the environmental assessment process and reporting directly to the President. China too has an elaborate environmental administrative network, including a national environmental protection agency and environment departments in all sector ministries. Since 1984, environmental impact assessments have been required for all capital investment projects. These developments signal a long term, serious interest in environmental quality on the part of Asian governments. Infrastructure construction will be more closely scrutinized than it ever has in the past.

Toward a World Bank Infrastructure Strategy

The complex web of changes underway in Pacific Asia has implications for the World Bank as well. We will need to strengthen our analytical and policy assistance to the high growth economies while making more project assistance available to the countries in the infrastructure crisis category. Some of the new approaches have long been proposed and advocated in the Bank's analysis and projects, especially those related to more efficient management practices and the importance of maintenance and operation in the infrastructure subsectors. For the future, the guideposts of a sound strategy for the World Bank incorporate the following priorities:

1. Increase lending resources for those countries in the infrastructure crisis category which adopt sound investment and manage-

ment plans. For Pacific Asia, this applies to Indochina, as those countries again become active borrowers.

2. Emphasize management improvements in all our investment projects and in our applied research. Improved maintenance and performance of public utilities is a top priority.

3. Provide analytical and technical assistance to those countries seeking to involve the private sector in infrastructure services.

4. Assist countries in their efforts to incorporate environmental assessment and regulation in their infrastructure programs.

5. Deepen our understanding of infrastructure's contribution to the growth process through analysis and research so that we can better advise governments on subsector priorities.

Let me conclude here with this thought. Today Pacific Asia is the scene of some very interesting departures from past practice in the infrastructure subsectors. Many of you in the private sector are already taking part in some of these creative fusions of public and private sector roles. We must acknowledge that today these first undertakings are more a function of necessity than invention. Public budgets simply cannot do all that is required alone. The question all of us have in our minds is whether these beginnings of partnership will evolve from expedience into accepted practice. Only time and positive results for all sides of the partnership will tell. I am optimistic. Of course there are pitfalls. But on balance I think the gains in capacity, efficiency, and performance will be there, and what we see today should develop into a self-sustaining momentum of proven practice and benefits.

Policies to Promote Free Enterprise in Emerging Economies

An address to the Wilton Park Conference, West Sussex, United Kingdom, February 25, 1991.

It is quite remarkable that today the first premise of development is that the private sector has to be the engine of growth—while only one or two decades ago the premise was that economic development is government's role. You will agree that this shift has been a remarkable development.

In my introduction today, drawing on my Bank experience with developing countries and examples mostly from Asia, I would like to cover the following topics:

- first, to briefly explore this recent paradigm shift and how it relates to the ultimate objective of efficiency;
- second, review some policies and practices that constitute growth enabling environments for enterprises, both public and private, and how the views about what is appropriate have evolved;
- third, investigate private sector development, both through attrition of the public sector and through privatization; and
- lastly, summarize the basic lessons we have learned on how to foster free enterprise.

Paradigm Shifts

In the 50s and early 60s, when most of today's developing countries became independent, the prevailing paradigm centered around Keynes/Domar theses on public spending for growth, and confidence in government policies to steer the economy. The new governments, following the accepted wisdom, relied on economic

planning and public funding of most activities, even more so as incipient private sectors were less able to attract the needed foreign capital.

Then in the 70s, what could in principle not happen, happened in the industrialized countries: stagflation. Disappointment with macroeconomic theories spread, and the search for a new paradigm began. Still, most developing countries experienced growth and improved incomes largely based on agricultural exports, while pursuing industrialization, largely based on import substitution and infant industry protection policies. Gradually, however, in many countries overextended public sectors became a constraint to growth as policies, programs and projects were poorly designed and implemented, distortions largely precluded development of efficient industry, either private or public, and capital became scarcer. Severe macro economic problems ensued. Not only was the paradigm failing in the developing world, but governance skills were lacking as well.

By the mid-80s, in a quite different world, it became commonly acknowledged that central planning and public ownership had largely failed. New schools of thought emerged; free markets, private enterprise and a minimalist role for government became the consensus view on what was right. Development strategies followed suit. Looking back there is no question that excessive interferences and controls by governments did not serve the development cause. Today, with the recent economic developments of Eastern Europe most would agree, as James Tobin put it, "on the collapse of central planning in theory, practice and ideology".

Why do I recapitulate this paradigm shift? For two reasons: first, to remind that past choices were not necessarily wrong at the time they were made. It is only with hindsight that "we know better." However, excesses did occur. The second reason, the corollary of the first, is that I expect that a more balanced paradigm will emerge on what is right for the 90s, as the scope for public/private ownership varies from country to country. In what follows I propose to focus on efficiency as a means for growth, and that should be our primary objective in the promotion of enterprises.

Enabling Environment for Growth

Few economists doubt now that free markets and competition through many economic agents—the antithesis of central planning, physical allocations, overregulation—is the better alternative for efficient growth. There is little disagreement that free and flexible determination of relative prices eliminates or reduces distortions, such as overvalued or pegged exchange rates and negative interest rates; or that excessive import tariffs and mandatory pricing of some goods, such as foodstaples, hinder growth. There is also little disagreement that governments need to concentrate on their intrinsic role, comprising the provision of macroeconomic stability, addressing basic social needs, protecting the environment; in short, to establish an enabling environment for sustainable development. And I must emphasize that enabling environments, normally discussed today with the private enterprise in mind, are needed just as much by the public sector enterprises.

But, even though there is agreement on the broad economic policy objectives just mentioned, issues are not black and white. Some governments are struggling to define the scope of the ultimate objectives; others, to define the transitional path; some have already dismantled a great deal of regimentations built in the past.

As developing countries attempted to enter this transition to a market driven economy, the Bank stepped in with new types of assistance. Traditionally, the Bank lent for investment projects, largely the construction of much needed public infrastructure. But from the early 80s we began to support programs that were required to ease the impact of oil price shocks and to finance the reform of key sectors. Adjustment lending through which the Bank quickly disbursed funds to support far reaching economic policy reforms, largely benefitted the poorer performing Latin American and African countries. But adjustment loans to the better performing Asian countries represented only 8% of the total loan amount approved for them during the period FY86-90. The Bank advice and lending for the reform process, is expected to continue.

Let me now go over some of the most important policy components of an effective enabling environment for private sector development and public sector management. First, I want to discuss macroeconomic policies.

Macroeconomic Policies. Today we know that a policy of macroeconomic stability is important to reduce the impact of external and temporary shocks, promote sustainable initiatives, contain inflation. We know that savers do not respond well to inflationary environments and that managers do not make optimal long term decisions in such circumstances. Prolonged excess spending is not sustainable. Rational central banking and monetary policies are indispensable. A well functioning financial system, including competitive private banks and capital markets is required; governments need to allow capital to move freely. Insurance regimes have to allow provision of adequate coverage; domestic ownership requirements should not hinder foreign investment; fiscal regimes should not penalize private initiative. No barriers should obstruct entry or the use of labor and land, or trade. The government should, however, regulate monopolies and imperfect markets.

Let me give a successful example of reform with such objectives in mind. In the mid-80s the Indonesian government introduced a structural adjustment program to counteract a collapse in oil prices and a sharp rise in the cost of servicing the external debt. That program involved a turnaround from their protectionist-interventionist policies. Over the following two years, domestic investments rose by 230% and foreign investments by 430%. This, by the way, was achieved before privatization of public enterprises had taken place.

Some countries also need to address particular problems in the macro policy arena. Resolution of debt overhangs may be a prerequisite for renewed investment and growth in those countries where large foreign debts absorb the full foreign exchange earnings. We know now that the traditional devaluation measure to encourage exports may trigger a devaluation/inflation spiral without solving the initial debt problem, as has been the case in Latin

American countries. Debt easing schemes supported by the international community may be needed to solve the impasse. Such schemes were, by the way, the subject of a conference in this forum last year. However, other views are being expressed that new "physical investment" is a superior alternative to debt buybacks even if the debt price is lowered in secondary markets. In socialist economies, transition has its pitfalls; for instance, potentially large inflation may well arise when subsidized input and non-monetary employee benefits start being priced at market values and their relative prices change. Trade-offs make choices difficult and results more long term.

Agricultural Policies. Now I want to focus on sectoral policies. When discussing free enterprise we tend to think about industries or modern services, but some of the more striking results from liberalization have been achieved in the agricultural sector. Let me quote the example of China and the more recent one of Viet Nam, a country that moved from being a rice importer to being the world's third largest rice exporter in one year, all because of a revised system of incentives. The new incentives comprised both land tenure reform and price reform, in combination with improved access to inputs and credit, and markets at fair prices. Small farmers are extremely responsive to incentives, and given that in most developing countries agriculture is the main economic activity, reforms in that sector are likely to be a precondition to growth in secondary and tertiary activities.

Policies for Competitive Industries. Turning now to industry and services, it is fair to say that policy issues are more complex. I will differentiate between industries that are essentially competitive, and those that operate in monopolistic markets.

With hindsight we know that highly protected industrialization involving competitive industries—with investment licensing, quantitative credit allocations, high tariffs—is a mistake. Infant industry protection policies fall into the "transitional gains trap": once given, subsidies are difficult to remove. A dynamic private sector fails to develop in what would otherwise be competitive markets. South Asian countries illustrate this proactive interven-

tionist model and the resulting pervasive presence of state-owned enterprises, high prices and low and disappointing growth.

But governments can also perform a proactive role successfully. East Asian countries and their unparalleled growth in the 80s demonstrated this thesis. Their industrial policy was a well designed mix of private sector incentives and public sector interventions. Their policy approach moved along two distinct, complementary paths:

1. promoting characteristics of a free market system through:
   - relying on export-led growth;
   - facilitating technological transfer;
   - keeping wage increases within productivity gains; and
2. providing proactive government support for industry through:
   - targeting growth industries and giving them functional support;
   - facilitating entry into international markets.

However, only two countries, Korea and Japan, have been successful at picking winners, and their success is probably even more difficult to replicate in the economic environment of the 90s. In the Bank we do not recommend such risky interventions.

The key to the proactive role is that it be limited and be embedded in free market tenets. Exporting required competitiveness but also increased market size and made possible increasing returns to scale from specialization in certain products. It is now accepted that more activities than once believed show increasing returns. Low or no tariffs on imports of inputs have avoided bottlenecks of industrial inputs. Low or no tariffs on imports of industrial equipment accelerated technological innovation and fostered productivity growth. Low wage increases, within productivity gains, avoided the transitional gains trap and provided dynamic consistency. The governments combined free market policies with some intervention; they absorbed some costs, such as for the promotion of domestic products abroad. And they retained public ownership of

industries whose minimum economic size was at the time beyond the possibilities of the private sector. And perhaps their most intangible accomplishment was the incorporation of private management style and discipline in public enterprises.

When governments are unwilling to liberalize fully, they can still make progress even with selective system reforms. Free trade zones provide examples of isolated successes. Consider Bangladesh: major trade reforms are needed, but the government allowed only a few reforms, such as establishment of a free trade zone for garments. As a result, garment exports, from nonexistent, grew in a few years to become an important share of exports. Such restricted efforts, however, only highlight the hindrance of the system on other activities and obstruct the vital linkages that form in unified markets.

And let's not forget the importance of administrative improvements even where governments are not willing to introduce any economic reforms. Improving public procurement practices and reducing payment delays can be effective in promoting small private contractors and suppliers in competitive markets, such as road maintenance—and in reducing costs to government. Simply reducing administrative red tape and simplifying procedures required for small business to be legal and have access to credit, for instance, have enormous pay-offs. Or, eased trade procedures can be almost as effective as policy reforms. And there should be no excuse for not introducing such administrative reforms.

Regulation of Monopolistic Enterprises. On the other hand, monopolies pose different policy choices for their regulation. In the past, most developing country governments chose to be the owners of enterprises that would have a natural monopoly, such as utilities. But today, the arguments which justified public ownership are weakening. For example, some of the natural monopolies are disintegrating with technological developments, as in the case of telecommunications; other monopolies have proved to be contestable, with the threat of entry by new enterprises rather than existing enterprises providing the competition; and some monopolies proved transferable to autonomous agencies or to the private sector with gains in efficiency. As a result, now private sector entry into markets previously reserved to public monopolies seems attractive.

Effective regulation remains the major difficulty. The needs are twofold: to formulate explicit policy and regulatory frameworks, and to develop public institutions for their monitoring. Achieving this, as we have learned, is a challenge: adequate regulations are difficult to formulate; few have been successful at internalizing externalities; markets have failed in unexpected ways—in the US savings and loan deregulation moral hazard was not foreseen; how to regulate contestable markets is still unclear—the US airline deregulation certainly has led to unexpected results. Furthermore, even where regulations are right, governments have limited capacity to intervene effectively and institution building has proven difficult and slow. Therefore, caution is necessary; liberalization or privatization of public monopolies may not lead to increased efficiency in the near term. But because of high potential gains, priority should be given to help developing country governments overcome these difficulties and provide an enabling environment. I will come back to this topic under privatization.

The Importance of Infrastructure and the Environment. Before turning to privatization, though, I want to say some words on the role of governments in providing infrastructure and in protecting the natural environment—another area of market failure—for sustainable development.

Investment in physical infrastructure is essential. Of course, capital expenditure should be integrated with a viable development strategy, since it is a function of government to ensure that public goods such as roads, ports, water and sewerage, power, are provided regardless of whether it is the public or private sector which actually finances, builds or operates such facilities. A key issue is whether infrastructure investments should anticipate demand or meet it; occasionally, the first priority is not investment but repair and maintenance. The challenge is not to miss opportunities to accelerate and guide development with forward looking, innovative investments.

Investment in social infrastructure is equally essential. It has long been known that the best asset a country can have is a well educated and healthy population. A recent Bank assessment of the outstanding results of Malaysia's economic policies over the last two decades points to basic education investments as perhaps the

single most important equalizer of incomes. And new thinking is emerging on more cost-effective ways governments can promote social services, for instance through budget reallocations to activities that lead to increased welfare, or through more effective programs within the same allocation. This is the area that policymakers have to protect during budget squeezes, because the social sectors may not have as vocal a support as others.

On the other hand, there has been a remarkable turnaround from indifference to concern about the environment. Governments now know that they have to address the negative externalities that private agents ignore when they are free to choose. Even more, these days it is common to hear about "perverse policies"—the policies at macro or sectoral level that turned out to have a negative impact on the environment, and that need to be changed. The challenge is to find the most cost-effective way to internalize externalities, to avoid penalizing private activities. This is more difficult in developing countries, where the possibilities of monitoring and enforcement are limited. Despite the difficulties, several Asian governments have recently introduced environmental legislation requiring cleaner industries and protection of natural resources, and others are in the process of doing so. Indonesia, for instance, is actively promoting industrial conversion to natural gas by making it more readily available; more generally, it is pursuing an energy pricing policy to encourage shifts to cleaner fuels. I may add that the Bank has environmental protection as one of its core objectives; as you may know, the Bank recently became the manager of the Global Environment Facility, which was established to finance environmental projects to reduce pollution problems of global concern.

Privatization

Having explored the policy issues which help create or undermine the enabling environment for growth, let me now turn to privatization issues. It has become clear to many governments that they need to let go of those activities the private sector can perform better; to avoid the crowding out or underutilization of the private sector and instead exploit its dynamic force. I want to

discuss two ways of privatizing: one, through sale of public enterprises, in particular those in competitive or potentially competitive markets; the other, through attrition of the public sector, in particular through increased provision of "public" services by the private sector. Either way, the objective is to enhance efficiency, to reallocate resources to more productive uses. Within the World Bank a lively debate is going on about the mechanics and the speed of privatization. I would like to relate some experiences from the Asian countries to illustrate the problems involved.

Divestiture of State-Owned, Commercial Enterprises (SOEs). Regarding divestiture, the Philippines can illustrate the heavy burden SOEs can be on public budgets and thus the justification for privatization, and how privatization can proceed. By 1983, the Philippine SOE sector had grown to comprise 300 firms and to drain the public budget by the equivalent of about 4% of GDP. The non-financial SOEs had yearly deficits of about half a billion US dollars in addition to yearly foreign debt payments of some US$ 125 million, both of which were absorbed by the government. Even so, maintenance and investments were deferred. The government, therefore, decided to undertake a reform program. First it reformed two large non performing, financial SOEs, and subsequently was able to sell some two-thirds of their assets that produced US$ 750 million in revenues. It also sold four of six commercial banks, that had been taken over when they failed, and 35 other SOEs. Some problems have also arisen, of course. The larger SOEs have yet to be sold; some of them were nationalized by the government, and the original owners and creditors are seeking compensation. Other SOEs will be consolidated, merged, restructured or liquidated. Shortage of both domestic and foreign capital, and perceived risks are slowing down sales. Still, great progress was made. I am glad to say that the Bank supported the reforms with an initial Economic Recovery Loan of US$ 310 million in 1987, followed by a loan of US$ 200 million for the Reform Program for Government Corporations in 1988.

In lower income countries, where the government usually has a large, poorly performing SOE sector, private entrepreneurship is limited and the domestic capital market is small. In such cases, for-

eign interest is usually weak or is concentrated in a single country or group. These constraints tend to slow a privatization program. Sri Lanka's recent divestiture program can illustrate:

- In the case of the textile SOEs, their international export quotas attracted foreign companies even though the SOEs could barely keep going under poor management and excessive staffing, despite low costs and the banking system carrying the losses. The foreign companies took over the SOEs' debt, as the purchase price, and expanded and modernized the plants such that staff was no longer redundant.
- The state-owned bus company was divested following a quite different process: a scheme was devised by which employees could buy the assets with their severance payments, and form smaller companies. Large losses had been accumulated despite the fact that at similar tariffs private operators were profitable. The government put an end to future losses although it had to take over the debt—which it would have had to do anyway.
- Other SOEs, however, so far have found no buyers. The government is proposing to restructure them in various ways: into a holding company; with management contracts; through assistance by foreign experts or the importers; and by staff reductions. The objective is to increase accountability, autonomy and competitiveness of the enterprises while still under public ownership.

I am also happy to say that the Bank extended this fiscal year a US$ 120 million credit to Sri Lanka, to ease balance of payment strains following the Gulf crisis, in recognition of the achievements under the SOE reform program.

In general, our experience in privatization programs shows that better performing enterprises are sold first, while the poorer ones do not find buyers. The process will identify those SOEs unable to cover even operating expenditures with total revenues; these SOEs, preferably, should be closed and their assets auctioned off, as they could hardly be profitable in the private sector either.

However, in a few cases, the worst enterprises are public because the government took them over from an ailing private sector. There the employment issue politically rules out exit from either the public or the private sector, and then seeking increased efficiency is a necessary course.

Privatization in socialist economies is more difficult, as it is not only a matter of privatizing all the enterprises, but of changing the structure of production and the whole cultural-economic system itself. The accumulated capital may be considerable, but is tied in the wrong assets, obsolete technologies, the wrong locations—and may still have to be paid for. Capital markets have to be developed; even financial systems at the enterprise level have to be developed. Emphasizing privatization of large public enterprises in such systems may result in fire-sales to foreign bidders.

While divesting large SOEs may pose more difficulties, the smaller enterprises generally pose less complex problems. The private sector can easily take them over even with limited capital and develop them in local competitive markets. Some governments are in the business of making bread, bricks, matches or selling groceries, originally motivated by equity objectives but ultimately resulting in shortages, limited selection and quality availabilities, and high costs. There are few constraints to divestiture in such cases, and immediate benefits arise both for the consumer and in the dynamic growth of entrepreneurs in small and medium businessprises, that provide the seed for larger and more sophisticated undertakings. Such sales, and related reforms required, should not be delayed in any regime.

Attrition of the Public Sector. But, there is also another way of "privatization": by attrition of the public sector. Certainly in socialist economies but also in others with widespread public ownership, economic growth can gradually decrease the share of the public sector, so that this becomes less pervasive over time. Rather than attempt to privatize major enterprises in a given sector, say energy, public policy can focus on strengthening and expanding the private sector counterpart so as to diminish the relative size and role of the public provider. This approach would

therefore proceed on two fronts: reforming SOEs and their framework; and allowing entry of private firms.

First, inefficient SOEs and their framework have to be reformed drastically. SOEs have to be forced to compete, among themselves and with private enterprises. Their normally soft budget constraints have to be hardened. The value of their assets has to be adjusted to their market values, just as it would have been if the SOE had been sold to a private firm, to make the SOE viable. Governments have to address the outstanding debt issue.

Second, entry into the sector must be open to private investors. It is now accepted that increased reliance on the private sector for delivery of some "public" services may cut costs and improve quality. Opening such activities to private sector ownership and participation may accelerate investment and modernization. The services range from low cost, low technology activities such as garbage collection that small and medium firms can provide, to high cost, high technology activities such as development and operation of public infrastructure or utilities, and banking services.

An important advantage of the "attrition" approach to public sector reform and private sector development is the avoidance of the difficult political issues involved in programs of privatization: no uproar over selling cheap or even worse selling cheap to foreigners, and potentially, less problems with redundant labor.

While still on this topic, let me point out that BOT—build, operate and transfer—schemes are not always as promising as they seem. Some reasons for the difficulties are first, that demand must be strong enough to make investments commercially profitable—but public infrastructure investments seldom are profitable, which is the reason why they are in the public sector to begin with; and second, as indicated earlier, a sound economy and regulatory and institutional capacity must be in place to avoid establishing a politically risky, private monopoly.

BOTs are, nevertheless, still worth pursuing selectively. Some BOTs have indeed materialized: in Indonesia, power generation will be increased by a new, private coal based plant, that is guaranteed a minimum sales volume that will feed into the electricity

grid still owned by a government corporation. And a private toll road is under construction. Those results are in stark contrast to the lack of investment and modernization in countries where demand is strong but governments have kept a tight control or ownership in these same areas. The Bank is investigating ways to participate in promising BOT schemes.

Before I end my introduction with a summary of some of the lessons learned about free enterprise promotion, and to illustrate the importance the Bank and I attach to the topic, let me mention that a few years back the Bank declared private sector development a core objective and adopted a specific program for action. Furthermore, a branch of the World Bank, the IFC, that lends exclusively to private sector firms, has experienced an explosive growth—commitments tripled between 1985 and 1989—and another branch, MIGA, was created to provide insurance against political risks to foreign investors. But even traditional Bank investment projects have helped develop the private sector. Such projects are executed by private contractors following competitive bidding, and in the poorer countries, some preference is given to domestic contractors to help them develop. The Bank also provides loans to financial intermediaries for lines of credit to worthy private firms. And all projects include an institution building component, with most also supporting policy reform.

General Lessons about Free Enterprise Promotion

Let me end my introduction to the conference by summarizing some lessons we have learned about free enterprise promotion:

- A good enabling environment, providing consistency and continuity, is a precondition for well functioning enterprises, both public and private.
- The reality is much more complex than the privatization debate; transitions are difficult, take longer and require larger amounts of funding than expected: speed rather than gradualism has to be an objective.
- Strong government commitment is essential.

- Public sector attrition and increased delivery of public services by private firms may provide an easier transition than the sale of SOEs.
- It is the better performing, commercially or at least potentially viable SOEs that can be sold most readily: in many cases, the essential step is to write down the capital worth to reflect expected returns.
- Care has to be taken that SOE privatization deals don't crowd out direct foreign investment into new private sector activities.
- Where capital markets are small, the method of sale can be controversial, especially if it is against credit or to foreigners.
- The worst performers may have to be restructured before they are offered for sale, and in cases, closed or auctioned off.
- Overstaffing and the threat of unemployment are often the most difficult problems to overcome in either public or private enterprise restructuring.
- The government has to be prepared to deal with the normally large outstanding debt of SOEs, whether they are restructured, closed or sold; and to make transparent consumer subsidies previously reflected as SOE losses.
- Measures of efficiency have to be developed and guide the privatization choice.
- The ultimate objectives have to be transparency, equity and efficiency.

I hope this introduction will enliven the debate and further the thinking on ways to accelerate enterprise development.

Asia and the New Balance in Development Strategies

An address to the World Institute for Development Economics Research, Helsinki, September 16, 1991.

Today, I would like to exploit the experience and intellect before me by raising for discussion a complex and much debated development issue—the role of government in the industrialization process. Another reason for addressing this topic at this time is the stimulation provided by some recent academic output on the East Asian NICs and their lessons for industrialization and development.[1]

What I would propose to do today is first review briefly this latest chapter in the long-standing debate on government, industrialization, and the economy, then offer a more pragmatic operational perspective on these theoretical debates, after which I will add some further evidence from Asia to demonstrate gaps in the debate, and finally conclude with some thoughts on the universality of East Asian paradigms.

What Do the NICs Prove about Development?

The Indian economist Jagdish Bhagwati has said, "Economic miracles are a public good; each economist sees in them a vindication of his pet theories."

I hope you will exempt *this economist* from Professor Bhagwati's observation, and I will gladly do the same for all of you. But *other*

1. Robert Wade, *Governing the Market: Economic Theory and the Role of Government in East Asian Industrialization* (London 1990); Stephen Smith, *Industrial Policy in Developing Countries* (Economic Policy Institute, Washington, D.C., 1991).

economists seem to be using the same body of evidence to support some very divergent explanations of why the NICs have prospered.

I have spent a good part of my professional life dealing with those countries and their policy makers. The facts are not that much in dispute. It is in the interpretation of Asian evidence and its support for different theories that we find the contention. Indeed, if the experience of the fastest growing developing countries in the world cannot be explained by a theory of industrialization and growth, then probably it should fall into disuse.

I think most of you know well the contours of this debate and its opposing schools. But let me summarize briefly. Most theories of Asia's success can be grouped into one of two categories, the "market supremacy" group, and the "government leadership" group. The market supremacy approach argues that the Asian NICs followed policies that conform to the neo-classical "consensus" of growth through efficiency, that is, removing distortions in factor and product markets so that resources will flow to their most productive uses, and confining government to a modest role in the economy, providing public goods, compensating for market failure, intervening functionally to assure more competitive markets and so on. Market supremacy proponents do not deny that Asian NICs have intervened outside of their model, but they believe those more selective interventions, "picking winners" to use another phrase, have been inconsequential.

Have they? According to the "government leadership" advocates, the role of government in high growth East Asia has been pervasive, interventionist, and effective in propelling these economies up from one "stretch of the river" to the next. Using many of the instruments that the new consensus paradigm says are ineffective and even counterproductive, governments in East Asia (except Hong Kong) have directed credit to chosen industries, employed public ownership of lead industries, heavily protected infant industries, and subsidized inputs of technology. Here we have a theory that urges getting some prices "wrong", rather than "right", to propel an economy out of one industrial niche into another.

Using evidence from Korea, and much more from Taiwan, Thailand, Malaysia and of course Japan, the advocates of government leadership have argued that the evidence in East Asia demonstrates that selective interventions made a difference and that the World Bank and other development agencies have ignored this evidence and offered flawed advice to the developing world. Too much emphasis on liberalization, deregulation, and privatization, they say, when in fact the most successful developing economies in the world demonstrate the effectiveness of more *dirigiste* approaches.

I cannot help but point out that those who are currently saying the World Bank has been "naive" in its free market advocacy, have obtained much of their evidence of successful *dirigisme* from World Bank studies. So the "naive" argument is not so convincing. But the content of our operational advice, whether it is dominated by one school of thought or another, whether it responds effectively to country conditions, are central questions, and well worth discussing.

The Bank's difficulty, in my view, is not inadequate data or analysis, or an overly ideological perspective; it is the interpretation of the evidence and its translation into effective development advice to countries facing very different challenges than those that confronted Korea and the other NICs in the 1960s and 70s. Those countries are asking for advice and taking decisions that foretell a new phase of reform in the 1990s, one in which the importance of markets is acknowledged and the positive role of government in managing reform is readily accepted. There are very few voices these days making the case for pure *dirigisme* or *laissez-faire*.

An Operational Perspective

The debate on industrialization and development provides an essential intellectual setting for policy making and advice. What I find most welcome as a practitioner is the increasingly pragmatic outlook of policy makers, who in the past were so often inclined to debate issues on theoretical grounds, rather than decide practi-

cal steps. Today, at the working level of government policy making, we find less interest in ideology and theory, and a shift to pragmatic issues of how, what, and when. Instead of abstract debates over public ownership of productive enterprises, for example, now we encounter questions on how to restructure the sector, using privatization, joint ventures, market competition, and other techniques to raise productively and lower fiscal burdens.

A number of principles underlie this growing pragmatic balance in Asia. One economic principle which is by no means new but has achieved grudging respect is that there is no free lunch. Countries which depend excessively on either domestic money creation or external debt end up in major crisis. This puts an effective lid on the ambitions of government to spend resources on industrial promotion. Another principle which has gained much wider recognition is that sustained development takes place in environments of a stable macro framework and free from distortions in prices and costs. We have also seen the definitive bankruptcy of central planning which goes with excessive government controls and public ownership as a model of development.

I would say that these principles reinforce the *necessity* for the sustained development of freely functioning markets. But we need to ask if good policies that allow markets to work are *sufficient* by themselves for rapid development to take place. Is there no role for coordinated change through institutions, banks, large enterprises and government? In my view there *is* a need for such coordinated change. But through which policy instruments, which institutions, what phasing, and under what circumstances of factor endowments, political and social conditions, and level of development—these are the pragmatic operational issues that need attention. The answers to each of those questions create for each country a unique set of opportunities and, I should add, some clear boundaries for government leadership in the economy. Korea's choices should not be mimicked, but observed, analyzed, and adapted to quite different circumstances.

Those different circumstances are found in countries such as India, Bangladesh, the Philippines and Sri Lanka. There the most urgent development problems are to a large part due to the failure of government policies. Their governments have hobbled produc-

tive activity by creating inconsistent price signals, by distorting factor markets, establishing negative value added public enterprises, protecting and overregulating domestic industry, and so on. Under such conditions the neo-classical consensus is a more practical framework. Our dialogue then, necessarily shifts to a series of negative imperatives ... don't protect, don't subsidize credit, don't own enterprises, don't interfere.

Because a number of our borrowing countries in Africa, Latin America and South Asia fall into that category, the World Bank has become prominently involved in programs of structural adjustment and reform. Structural adjustment is the most high profile work that the World Bank performs, and it necessarily has come to overshadow the work governments do (and we finance) to strengthen government institutions, to build up economic and social services, to construct and operate public infrastructure, stimulate industry and trade, and develop agriculture. This structural adjustment optic, through which so much of our development practice and advice is seen and analyzed, distorts perceptions so that all our advice is seen as urging government withdrawal and inactivity.

In Asia there is a more diverse profile of operational activity, most of it in the form of investment and sectoral reform projects in agriculture, infrastructure, industry and the social sectors. The hard edged adjustment operations, with explicit conditions on import liberalization, price reform, industrial deregulation and privatization and so on are there, but currently they are less than 10 percent of the value of our projects planned for 1992-94. Most Asian countries, including South Asia, have not required frequent crisis-driven stabilization and adjustment programs, and, I would judge, our advice has had many positive as well as negative imperatives.

Advice and Adjustment in Asia

The question that still hangs over this discussion concerns the theoretical balance of advice the Bank has offered to the crisis economies and whether that advice has been appropriate to country circumstances. Let me touch upon some Asian cases. I am thinking of Indonesia during the 1980s, Sri Lanka since the mid 1980s,

and now India in the early 1990s. All three have experienced or are experiencing serious macro-economic imbalances which have compelled them to seek adjustment loans and credits from the World Bank. Each, as we shall see, faces a distinctive set of problems, calling for carefully tailored adjustment strategies. As will be apparent, models of market supremacy or government leadership are not especially useful in their pure forms. China's approach to reform is also distinctive, and again departs from theoretical approaches.

Indonesia. Indonesia encountered a severe balance of payments crisis in the early 1980s due to the fall in global petroleum prices and other factors. The ensuing adjustment program has been distinctive in several respects. First, the agreed program sought to protect public services to the rural areas, including the poor, while reducing fiscal deficits and restoring macro-stability. Second, the government decided to build incentives for the rapid expansion of the non-oil sector, so that the dependence on oil exports could be lessened and the manufacturing base diversified. Third, the growth of the private sector received the highest priority, and policy and expenditure decisions created, step by step, a more favorable environment for private investment, both domestic and foreign.

The results have been uncontestably good. Non-oil export growth has consistently exceeded GDP growth. The proportion of oil exports has declined from 80 percent of total exports to about 44 percent over the decade. Poverty reduction has exceeded objectives, with dramatic gains achieved during the adjustment period. And notably, Indonesia's extensive ownership of public enterprises was not substantially privatized during this period, but subjected to market forces and competition so as to improve profitability and lower the overall budget burden. This implies a policy of attrition of the public sector, as it remains largely unchanged in size, while the private sector rapidly expands.

Sri Lanka. In Sri Lanka, the picture is quite different. Historically a state which has spent heavily on social and economic programs, Sri Lanka in the second half of the 1980s was confronting unsustainable fiscal and current account deficits as well as mounting foreign debt obligations. Government expenditure, at over 30

percent of GDP, and public employment, at over 20 percent of the country's labor force, indicate how large the public sector and its appetite for national resources had become. The adjustment program Sri Lanka embarked upon thus has among its objectives the expected macro stabilization and deregulation of the economy, while on the structural reform front, reduction of public spending as a proportion of GDP and the privatization of the large public enterprise sector are the highest priorities. Public enterprises alone account for 10 percent of GDP. Whereas Indonesia needed to focus public expenditures more equitably and deregulate the economy, Sri Lanka's most pressing problem is the size and economic role of the state, which must be brought closer to its low income competitors (global average of 23 percent of GDP). Results so far exceed expectations on the macroeconomic front, while privatization and reduction of untargeted welfare expenditures are progressing on schedule. Growth last year was over 6 percent, well above projections.

India. Turning to India, you are all well acquainted with that country's recent macroeconomic difficulties, which have many deeply etched links to growing fiscal deficits and a large cluster of acute productivity and efficiency problems in industry, the public enterprise sector, the trade regime and the financial sector. Over the past four years I have spent much of my time discussing these issues with Indian policy makers and intellectuals. Contrary to what one would have expected 10 years ago, our conversations have been overwhelmingly technical in tone, focussing on how far to go with reform, its timing, its phasing, its political and social constraints. Old ideological disputes between central planners and free marketeers have been notably absent.

This has carried through to our current dialogue on the content of the government's stabilization and reform program, which the World Bank is supporting.

Let me highlight just a few of the distinctive features of the Indian program. First, many important reforms have already been announced by the Indian government, thereby establishing the clear Indian ownership of this structural adjustment program. Second, the reform package takes direct aim at the pervasive system of industrial licensing which has been a pillar of India's heavily

planned approach to industrial development and has regulated all aspects of entry, expansion, diversification and modernization of industrial firms in India. Third, India will take steps to contain the growth of the public enterprise sector. Private firms that are failing will no longer be absorbed by the public sector, and automatic restructuring and closure proceedings will be established for failing public firms. Again, the thrust of this program is a shift away from government controls and ownership, simply because their pervasive role in the economy has placed limits on productivity improvements, investor response, economic growth, and, most important of all, the pace of poverty reduction.

China. The other Asian giant, China, cannot be included among the small number of Asian countries confronting balance of payments crises. Rather, China's far reaching reform program has been focussed on the internal challenges of moving from plan to market, a formidable set of problems indeed. Although these have included macroeconomic issues, particularly inflation, the overall macro performance of this economy has been remarkably stable and dynamic. Growth rates have averaged almost 9 percent over the past 7 years, and creditworthiness has been maintained at a high level.

Reform in China has been accomplished in stages and in spurts over time, with lessons learned at each step. The more recent growth of the vibrant village and rural enterprise sector and its contribution to exports and employment are major achievements to be added to the first successful stage of agricultural reform. Some of the lessons of the Chinese experience pinpoint the importance of waiting for the right moment, of timing reform in concert with complementary conditions. For example, full liberalization of prices has been most practical when a clear majority of administered sectoral prices are not too distant from market clearing levels. Similarly, the surest path to an inflation free transition to market prices is under conditions of adequate supply of products, inventories, and unused manufacturing capacity, rather than under conditions of scarcity. Issues still to be tackled are further price decontrol, enforcing a hard budget constraint on public enterprises, removing restrictions on labor mobility, and a shift to

private and popular ownership of public enterprises. That China has deferred many of these issues and still managed the transition successfully so far is another indication of how wide a range of reform approaches one finds in Asia and how difficult it is to prescribe one narrow strategy or theory for all.

Let me mention one other case. In Bangladesh, the inefficiency of government management of some activities is very costly and uses huge resources that could help spur growth and poverty reduction if employed productively. In the power sector, the amount lost in system leakages and wastage in five years would be enough to finance the entire construction of the Jamuna Bridge, now the largest investment project planned in Bangladesh. Public enterprise deficits are another source of inefficiency. If those deficits could be reduced to zero, the total annual savings would equal *half* the annual foreign aid commitments to that country. Those public expenditure problems occupy much of our country dialogue with Bangladesh.

Paradigms and Lessons

I should return now to the contending paradigms with which I began this talk. Some would phrase this problem as a choice between a rapacious, rent seeking entrepreneur whose firm will disappear if he fails and an incompetent, corrupt bureaucrat who will be promoted no matter what he does. East Asia tells us quite eloquently that neither side of the bargain is inevitable; entrepreneurs in the form of Korea's *chaebol* seldom disappear; and bureaucrats have proven themselves dedicated and above all competent. What about the rest of the world? Is it reasonable to expect from the public sector in Bangladesh, Viet Nam, Philippines, Nigeria, and Pakistan the same level of performance found in Korea? Our *World Development Report* just published has examined this question on a global basis and concludes as follows:[2]

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2. World Bank, *World Development Report 1991* (New York: Oxford University Press, 1991), pp. 131-140.

- Markets fail but so do governments: in economic terms governments may fail because they are pursuing administrative, redistributive, or political objectives, and their interventions in the form of subsidies, or state owned enterprises, or tariff protection will benefit narrow interest groups, rather than the poor or society as a whole.
- Excessive intervention breeds corruption: corruption flourishes in situations where domestic and international competition is suppressed, rules and regulations are onerous and discretionary, and civil servants are underpaid.
- Intervention creates vested interests which make it difficult to change the policy: protection of infant industries for example is exceptionally difficult to remove, because firms come to rely on protected markets and the profits they deliver.
- Crude transfers through price subsidies most always end up worsening the distribution of income rather than improving it, as in the case of fertilizer subsidies benefitting the fertilizer manufacturer or rich farmers.

I have seen all too many examples of these pitfalls and failures in developing countries, including my own. That they tend to recur with regularity all over the world would seem to be sufficient justification for limiting government within the neo classical boundaries I mentioned at the outset: infrastructure, education, law and order, institutional support for the smooth functioning of markets, human capital investments and services, protection of the environment. In that way, the downside of government intervention is closed off and the policy environment for the private sector is more "market friendly." As I have indicated earlier, the majority of the Bank's developing country borrowers need advice on how to rein in overextended, counterproductive public sector intervention, not to expand it.

But is that the optimal formula for dynamic growth? Don't the Asian NICs plus Thailand, Malaysia and even Indonesia tell us that government's role must go beyond these narrow confines if dynamic comparative advantage and rapid economic growth are the objectives?

Let me make three basic points. First of all, not everybody can fit on top. There are good reasons having to do with human resource endowments, governance factors, and even culture that give one country a competitive edge over another in the race for industrialization and growth. Analysts point to the homogenous ethnic composition of most of these successful states, their corporate policies emphasizing unity and cooperation, the advanced educational qualifications of the work force at the outset, a tradition of impartiality and excellence in the civil service, and for some a national ethos rooted in a sense of vulnerability and struggle against outside forces. These are not easily replicated starting conditions.

Second, the few examples of effective, prudent intervention found in East Asia need to be placed in the wider context of consistent failure to succeed with these tasks elsewhere. Intervention is and remains a potent temptation for governments; most seem to underestimate its level of difficulty and overestimate their own administrative capacities. This makes the East Asian record all the more remarkable in that they have been able to institutionalize such arrangements successfully and without succumbing to the private interests they are assisting.

Third, the heavily weighted evidence of developing country experience imposes caution and humility on those who would urge selective intervention in industry, trade and credit. What may have worked for Korea in the global economic environment of the 1960s and 70s may be less fruitful in the 1990s. Moreover, the "market friendly" character of Korea's interventionist policies provided an essential discipline and a rationale for dropping those policies (and subsidies) that did not work.

But let us not overgeneralize from the failures and problem cases. I will confess that some of my colleagues are a bit impatient with their role as naysayer, and I will add my name to the list. If development were confined to undoing mistakes, it would be a dull profession for all of us. The East Asian NICs and their successful emulators are a powerful argument that a more activist, positive governmental role can be a decisive factor in rapid industrial growth. An urgent task for the World Bank is to perform more research into East Asian approaches to trade and industrialization,

including the experience of Japan. What is replicable and transferable must be brought to light and shared with others.

In the era of pragmatic reform unfolding in the 1990s, the World Bank can hardly afford to ignore what has worked well. We will need to update our advice with the benefit of new experience and research. No country in Asia accepts our advice on faith, nor should it.

Strengthening Development Cooperation in Asia for the 1990s

An address to the Japan Center for International Finance, Tokyo, May 23, 1991.

During the last few years major changes have taken place in the global economy. The socialist economies have begun a determined search for appropriate market oriented systems. A consensus has emerged that the problems of environmental degradation are demanding urgent national and international actions. And there is renewed interest and concern for the ravages of poverty, illiteracy, poor health, and rapid population growth in the low income economies of the world.

For many years, Japan and the World Bank have been working together to improve the quality and levels of foreign assistance to developing countries, particularly those in Asia. Now that Japan is seen more clearly as a key actor in the world economy and has assumed the position of the number one bilateral aid donor, it is appropriate to ask if that collaboration between the World Bank and Japan could be further enhanced and more effectively focused on emerging development issues. I think that conditions are favorable for an expansion of our partnership.

I would like to use this occasion today, to present some thoughts on this important subject. In this new phase, Japan's intellectual contribution to development and adjustment will be just as important as the Japanese aid funding. I will propose some specific areas for enhanced collaboration between Japan and the World Bank and indicate some modalities for it. However, before coming to my main thesis let me briefly review the emerging issues in Asia and the need for concerted action to address them.

Development Issues in Asia

Every year we measure Asia's record of achievement and place it in the context of development challenges facing the region. In recent years our overall view of Asia's prospects has been strongly optimistic and hopeful. Despite the seriousness of the problems, we have been persuaded that the favorable policy and institutional context provided the foundations for sustained progress for the region and in general our optimism had been justified by events. However, this year we see some disturbing developments. In several countries questions are being raised as to whether the momentum of structural reforms is not slowing down. In many there are growing political tensions with increasingly ominous interactions between poverty, population growth, and environment. These concerns temper our usual optimism. We still believe that with enhanced regional efforts the growth process in Asia can be revitalized; however, that will not happen automatically. Conscious and concerted efforts are needed for that purpose; and Japan, in collaboration with other development partners, can play a lead role in these efforts.

Let me illustrate with some facts and figures. During the 1980s Asia's performance was impressive: per capita income grew by 5.2 percent per annum, which was a considerable acceleration in relation to its own past performance and, of course, much higher in relation to other parts of the developing world. The income growth was also associated with significant improvement in social indicators. Since the Asia region holds about two-thirds of the population of the developing world, this improvement in economic and social indicators for the region was indeed good news for the development community. It gives credence to the view that development strategy can work and the donor community can make a difference through its aid as well as policy advice.

However, while the experience of the 1980s is a cause for confidence, it is not a cause for complacency. A large part of Asia's success was due to the continued good performance of rapidly industrializing open economies of Asia which now comprise not only Korea, but also Thailand, Malaysia, and Indonesia. Let me focus attention on the case of Indonesia, which was hit hard in

the early 1980s by declining oil prices and an appreciating stock of foreign debt, both of which compelled Indonesia to cut back on public expenditures in order to restore macrostability at a lower rate of economic growth. You are all aware of that country's adept management of a difficult adjustment process and the resulting recovery of rapid economic growth in the second half of the decade. I would be pleased to entertain further discussion of Indonesia and other Asian countries of interest at the conclusion of my remarks. The 1980s also saw the emergence of India and China as accelerators of the region's growth, but more recently macroeconomic strains were beginning to be evident in both countries.

For other countries in Asia, which include Bangladesh, Laos, Myanmar, Nepal, Papua New Guinea, The Philippines, Viet Nam and Pacific islands, the growth performance was poor during the 1980s. Some of these countries experienced an average annual decline in per capita income during the decade while others experienced only modest gains. In most of these countries, there were serious problems of macro imbalances, structural distortions, along with the problems of capacity building and unsustainable population growth.

We believe that if Asia is to resume its impressive performance of growth with equity, it needs to launch a second wave of reforms, make more determined efforts for poverty reduction and population control, and initiate a concerted program for environment-friendly development strategy. During this period, ideas will be just as important as finance for promoting development.

World Bank Activities

Let me now turn to what we at the World Bank have been trying to do to assist in tackling these issues.

Asia is the single largest region for the World Bank operations, accounting for approximately 34 to 40 percent of total Bank lending each year. The cumulative portfolio of 538 active Bank financed projects in Asia has a commitment value of $51.5 billion. In FY91 lending volume is expected to be about US$8 billion, covering about 60 projects, almost all of which are investment as opposed

to adjustment operations. Similar to the emphasis in the Japanese aid approach, our lending for balance of payment support has been used selectively and maintained at a modest level in Asian countries. Much of our lending for private sector development and public sector reform has been built into more conventional investment projects and sector investment operations. This also has been the case for the growing number of projects directed at reducing poverty and improving the natural environment. Our core poverty programs and core environment program each total more than US$1 billion of lending for FY91.

Our lending operations are closely coordinated with our analytical work. We have almost 600 development experts working full-time on monitoring economic developments in Asian countries and developing policy and project proposals for accelerating growth with equity in these countries. There is hardly any other institution in the world that has comparable analytical and project capacity in the development business. Over the last few years we have been completing about 50 major studies on Asian countries every year covering issues of structural reforms, poverty, social sectors, and environment. Our economic and sector work puts emphasis on learning from the experience of the dynamic economies of East Asia and on building the momentum in countries in favor of structural reforms which are most effective when they are voluntary and consistent.

Japan and Development Cooperation

The dramatic success of Japan's economic development is reflected in its extensive collaboration with the World Bank. Their mutually beneficial history of partnership traces its roots back to 1952, even before Japan became a member of the United Nations. From 1953 to 1966 Japan was an active borrower from the World Bank.

In 1970 the roles were reversed when Japan opened its capital market to World Bank borrowing. Today Japan is one of the Bank's largest sources of borrowed funds for its lending operations and its biggest partner in cofinancing. Since 1970 Japan cofinanc-

ing of World Bank-assisted projects has totaled $12.5 billion, with half of that going to Asian countries. Most of this has come since 1987, when Japan launched its Recycling Program. Japan also has generously expanded its contributions to the International Development Association, the Bank's concessional lending affiliate serving the poorest developing countries.

Japan is thus a success story of development cooperation. It has now emerged as the number one aid donor in the world and will continue as a dominant contributor not only through ODA, but in other forms of assistance, including foreign private investment, during the 1990s and beyond. However, *Japan's importance derives not only from its financial contribution. Equally important are the lessons to be learned from the Japanese approach to foreign assistance and development.* I believe that not enough effort has gone into articulating these aspects of the Japanese contribution to development. Let me give some examples.

The Japanese approach to aid and development has always been firmly embedded in mutuality of interests and support for a self-sustaining partnership for growth based on private sector transactions and sound public investments. Moreover, Japan's foreign assistance has been notable for its consistency of approach over time, a useful characteristic for its partner countries. Japan has also traditionally given priority to aid for investment and has been concerned about the adverse long-term consequences of excessive emphasis on balance of payments support. These principles embody a lot of wisdom, and derive from the rich development experience Japan has accumulated in two long periods of industrialization and growth.

Japan's approach to development has been widely emulated in Asia. The Malaysian prime minister's slogan "Look East" may be the most dramatic presentation of this thesis but many other countries, including Korea, Singapore, and Thailand, have implicitly or explicitly drawn upon the Japanese experience while adapting the strategy to the changing world environment and making it congruent with their own history and background. The emphasis that the Japanese approach puts on partnership rather than on an adversarial relationship is a particularly important one. This ap-

plies to partnership between state and private sector, between labor and capital, and between nation and nation.

The nature of this partnership will, of course, depend on the social and political circumstances of individual countries, but it may be particularly important for an emerging area of concern in many Asian countries, namely the issue of labor relations. As I noted already, it appears that success of many structural reforms is hampered by the problems connected with exit policies of firms. Japan seems to have effective policies for handling sunset industries and retraining and relocation of labor. The lessons of these and other experiences could be more thoroughly researched and disseminated to other developing countries, tasks which the World Bank is well positioned to perform. Increased involvement of the Japanese in the staffing of international institutions can also help expand the field of choice for valid development strategies.

In recent years, we have talked a lot about which areas governments should best leave to the private sector. That is important. But the Japanese experience also tells us that there are things governments should do and how they can do it better. As the World Bank's new Chief Economist has remarked recently, ". . . taking the brakes off is not enough to make your car go, and crash diets do not ensure continuing health. . . . The view that governments should simply swear off selective policies if they cannot do them well may be a bit naive. The same political forces that make them unable to do them well may make them unable to resist engaging them." These ideas suggest a need for a careful and open-minded look at Japanese approaches to industrialization and finance, where government's role has been more positive and clearly effective.

Areas for Enhanced Cooperation

I am convinced that we can *build an even more productive collaboration between the World Bank and Japan for Asia's development in the 1990s*. There is a need for cooperation, not only for pooling financial resources but also for pooling ideas on aid philosophy and development experience. Like any other partnership, this will be mutually beneficial. I believe that Japan's contribution to develop-

ment, already substantial and growing, can be made even more effective in close partnership with international financial institutions. If the idea of a special initiative to strengthen that partnership takes hold, we will, of course, have to do a lot of detailed work to operationalize it. However, let me utilize this occasion to indicate some areas where enhanced cooperation would be appropriate right away. Among these areas are: universal primary education in Asia, environmental protection in Asia, trade and private sector development, and lastly strengthening investment preparation capacity, particularly in the least developed countries such as Nepal, Bangladesh, and Laos. Let me say a few words on each of these.

Achieving Universal Primary Education in Asia. One of the most striking lessons of modern economic history over the last two centuries is that the leader in schooling invariably is the leader in development. Education has been found to be crucial, not only for growth of productivity but also for promoting equity between social groups and between genders. Japan's educational system is certainly a case in point, but more needs to be known about how Japan's approach to education has yielded unusually high benefits and how those attributes can be adapted to developing country circumstances.

Despite its obviously important role, primary education has not always received the attention it deserves either from governments or from donors. The number of school-age Asian children not attending school remains large today—about 70 million representing nearly half of the worldwide total of 145 million out-of-school children in this age group. Most of these children are concentrated in three countries—India (35 million), China (12 million) and Bangladesh (7 million). The problem arises not so much due to low rates of entry into school as to the high dropout rates. Even for those who remain in the system, quite often the training level is woefully inadequate due to poor quality of teachers and substandard facilities.

While education is more than a mere matter of money, lack of resources has been a serious problem. India, Bangladesh and Nepal devote only 0.7 to 0.8 percent of their GDP to primary education, about half the average in Asia, and barely a third of the ratio in

the best performing Asian countries such as Korea and Malaysia. The donors have also neglected the primary education sector. International aid flows for primary education in developing countries averaged only 4 per cent of total aid flows to the entire education sector from 1981 to 1986. Asia received about 15 per cent of global aid disbursements to primary education for a school population of some 300 million children. There are, of course, reasons for inadequate support from donors for primary education. Among these are the lack of a direct link between aid and imports from the donor countries, donor preference for high visibility projects, and often the recipient governments' desire to minimize foreign influence in an activity which is perceived to have a central role in inculcating national cultural values.

None of these problems is insuperable. Typically, aid funds will directly or indirectly end up financing imports, so that the need for a direct link between aid and a foreign exchange component is not so important, particularly for countries like Japan which has a competitive edge in world trade. Given the importance attached nowadays to social development, donors' visibility in a concerted education program could in fact be quite high. Lastly, cultural sensitivities on the part of recipient governments can be addressed and overcome, as the growing levels of international assistance for education demonstrate.

While the achievement of universal primary education will require additional resources, it is important to emphasize that the amount of resources involved is not large in relation to the GNP of these countries. For Bangladesh, India and Nepal, where the number of children out of school is relatively high, national expenditures on primary education would need to just more than double between now and the year 2000 in order to gain system improvements capable of delivering universal primary education in the year 2000. This still would be well below 2 per cent of their GNP. For China and the Philippines, expenditure increases would be considerably less, 14 per cent for China and 40 per cent for Philippines over current levels. As a rough order of magnitude for all five countries, spending on primary education would need to increase by 3.5 per cent per year or an annual average increase of $346 million sustained over 10 years.

Environmental Protection. The combination of rapid economic growth, population density, and poverty is placing severe stress on Asia's physical environment. The magnitude of the problems of land degradation, water and air pollution, deforestation and loss of biodiversity is becoming ominously clear.

Atmospheric pollution in Asia presents a global threat. Today Asia produces 20 percent of the world's greenhouse gases. Emissions in India and China are growing by 6-7 percent per year, while industrial world emissions are growing by less than 1 percent. Left unchecked, these two countries in the next twenty years will more than double their CO_2 emissions and offset the 40-50 percent reduction in CO_2 output being proposed in some industrial countries. The growth of SO_2 emissions in Asia is similarly troublesome. Today China's SO_2 emissions are 18 million tons per year, compared to 1.1 million tons from Japan. India emits 7 million tons and Thailand 3 million tons. Left unchecked, Asia's contribution of global SO_2 will grow from 28 million tons to 76 million tons in 2010. Asia consequently presents the greatest single threat to the world's environmental balance in atmospheric pollution.

Degradation of forests, land, and water is also a serious threat. Deforestation of Asia's forests has reached an estimated 4.7 million hectare per year. Without sustainable management, these forests—and their rich biodiversity—will all but disappear in the next century. Land degradation, particularly in South Asia, has begun to affect agricultural output. Almost 50 percent of India's cropped area is classified as degraded. Water quality is also deteriorating, while competition for water is growing. Waste water severely pollutes 70 per cent of China's monitored rivers, and nearly all major cities relying on groundwater draw on contaminated supplies.

These environmental hazards, unless confronted, will eventually result in reduced economic growth, intolerable living conditions, particularly for the poor, and massive investment requirements for rehabilitation and protection.

The industrialized world is learning how to control some forms of pollution. Effective methods to control soil erosion and ensure water quality are also available at a price. Technology and policies

for managing tropical forests on a sustainable basis are not as well developed, but research is continuing. However, in developing countries the application of the appropriate policies, incentives and regulations, and technology for environmental protection is relatively new. Probably the most important issues are cost and the relationship between investment in environmental protection and economic growth and employment. Atmospheric pollution control in power plants adds about 20 percent to their cost (e.g., for SO_2 emissions). If Western standards were to be achieved in China alone, this would mean an additional US$22.5 billion investment budget during the 1990s in power development costs.

Most developing countries are reluctant to use scarce investment resources for pollution control while their industrial, energy, and infrastructure base remains underdeveloped. They will not want to forgo increased capacity and growth even if experience elsewhere demonstrates convincingly that up-front investment in environmental mitigation is less costly than subsequent rehabilitation and restoration. Many still maintain they cannot "afford" an environmentally benign development effort, without significant support from the industrial world and the international community.

Japan has emerged as an international leader in emission control technology and would be a major supplier of equipment and technology in this area if there were a world-wide effort to mobilize funds for projects to reduce gas emissions in Asian countries, particularly India and China. Japan would also be a major beneficiary from reduced risk of acid rain due to pollution in East Asia.

I am happy to note that the Japanese Council of Foreign Economic Cooperation has recommended that Japan should take a *lead* in expanding and strengthening assistance in the environmental field in order to achieve "sustainable development on a global scale." The council urges actions to deepen the understanding of the governments of developing countries regarding the importance of environment conservation and calls for making use of the knowledge and experience of international organizations. We in the Asia Region of the World Bank are strongly committed to promoting environmentally sound development in Asia and

would like to explore all avenues for partnership with Japan in this important task.

Trade and Private Sector Development in South Asia. In the past, the US and Europe were the main destinations of Japanese exports. In recent years Asia's share in Japanese exports has been increasing and it is now larger than that of the US or Europe. During the 1990s and beyond, Japan may have to be prepared for a further decline in the share of their exports to US and Europe. US budget and trade deficits are clearly unsustainable in the long run, and reductions in these deficits will probably be associated with a reduced rate of growth of imports in the US. Similarly, with further progress in European integration, including Eastern Europe and the Soviet Union, internal trade in Europe is likely to increase faster than imports from abroad including Japan.

Our calculations suggest that Japan can maintain its rate of growth of exports of the 1980s without any increased penetration of the US and European markets provided Japan can maintain the same rate of growth of exports to Asian neighbors that it attained during the second half of the 1980s (about 15 percent per year). The Asian countries *can* finance these incremental imports but only if corresponding efforts are made to facilitate exports from these countries to Japan, along with increases in capital inflows from Japan into these countries in the form of private investment, concessional and non-concessional aid, and further opening of the Japanese financial markets to the Asian countries.

In this context it is appropriate to highlight the importance of South Asia, that is India and her neighbors, as a potential growth point for increased trade and capital flows between Japan and Asia. The present shares of Japan in exports from and in imports to the countries of South Asia are low. So are levels of ODA and private investment from Japan to South Asia. In 1989 net ODA from Japan to all of South Asia was US$890 million as against US$1.1 billion to Indonesia alone; out of Japanese foreign private investment of about US$5 billion in 1989, all of South Asia received only US$19 million.

There are, of course, historical, political, and policy reasons for this situation. However, there are a number of indications that

this imbalance within Asia is changing and indeed should change more rapidly. It is noteworthy that the Japanese shares in imports, exports, and foreign private investment in South Asia are low but *increasing* while those of East Asia are declining (though high). South Asian countries are undergoing major rethinking on their policies, and enhanced collaboration with Japan could expedite the pace of reform and also increase the effectiveness of reforms through provision of funds. With policy changes, there may open up significant opportunities for twinning arrangements between business houses in Japan and in South Asian countries. Japan, for its part, could relax tariff and non-tariff restrictions on imports from other Asian countries, open up its financial markets to fund raising by creditworthy Asian neighbors, encourage foreign private investment, and raise ODA commitments. The Bank stands ready to collaborate with Japan in efforts to play a larger role in South Asia growth and industrial developments.

Development Project Preparation Capacity. Lastly, I come to the issue of building capacity for preparation and implementation of development programs. It is generally agreed that in several low-income countries, particularly the least developed countries such as Bangladesh, Nepal, Laos, Vietnam, and Myanmar, investment rates are unacceptably low. In many of these cases the problems arise due to inadequate capacity for project preparation and project implementation. This relates to lack of technical capacity as well as institutional and administrative capacities. Unless this capacity is improved, additional aid money is likely to end up in consumption and/or policy distortions. It is, therefore, urgent that an effort is made to improve the capacity for project preparation and project implementation. The amount of money involved may not be large but special innovative efforts will be needed in view of our limited progress in this respect in the past. Japan could use trust fund programs with the World Bank more actively to assist in this area.

Modalities. The modalities of enhanced cooperation between the Bank and Japan will need to be worked out. Possibilities include joint studies, joint missions, joint feasibility studies, and joint financing.

During the 1990s, I would like to see Japan and the World Bank strengthen our cooperation in the intellectual field. We may, for example, undertake joint studies on major regional issues such as environment or restructuring of labor relations for adjustment. We may undertake joint missions to Asian countries to explore ways of helping private sector development, in particular, foreign private investment. We would welcome secondment of Japanese experts to our region for helping our borrowers in designing their development strategies, including trade, industry, and financial sector reforms. These efforts, of course, will cost money; and we hope that Japan will be able to maintain its rate of growth of ODA achieved during recent years.

Summary and Conclusions

Before concluding, let me restate my major themes:

- The development performance of Asia during the 1980s has been impressive, both in relation to the past and in relation to other parts of the developing world. However, for a number of countries in Asia there was hardly any growth in per capita incomes during this period and for many of the Asian countries, including India and China, there remain some serious problems of macroeconomic imbalances and structural rigidities.
- During the 1990s a second wave of structural reforms are needed in Asia, drawing more fully on the Japanese experience and putting an increased focus on dynamic trade and technology relations, private sector development, and environmental protection, while continuing the emphasis on family planning and poverty reduction.
- The long history of partnership between the World Bank and Japan needs to take new dimensions. In this new phase, the Japanese approach to aid and its strategy of development and adjustment will be just as important as Japanese aid funding.
- While the partnership would cover many areas of development, special efforts are called for during the 1990s in the areas of primary education, environment, trade and private sector in-

vestment, and strengthening of public sector capacities for designing and implementing development programs.

- The modalities of such partnership need to be developed but they would include not only joint financing but also joint research programs, joint feasibility studies, and joint country missions.

I believe that we are at the beginning of a new era of Asian development. Forecasting is, of course, always a dangerous business. However, there is a high probability that in the emerging new world order Japan will play a lead role in aid and economic matters. Asia provides a natural starting point for Japan's enhanced leadership in this area. If the World Bank and Japan can develop effective modalities for expanded collaboration, this would serve well the cause of development in general and Asia in particular.

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